The New York Times

Business

INSIDER

The Bankruptcy Development That Has Wall St. Worried

Joe Tabacca/Bloomberg News

Michael Berger, right, with his lawyer, Joseph Bondy, in 2002. Mr. Berger pleaded guilty to fraud, but later fled the country.

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Published: February 23, 2007

LAST week, Burton R. Lifland, a judge in the Federal Bankruptcy Court in Manhattan, ordered Bear Stearns to pay almost $160 million to investors in a hedge fund for doing business with that fund but failing to detect that it was a fraud.

The case has been received with true fear on Wall Street, where servicing hedge funds is a business so lucrative that it makes the go-go years of bringing technology companies public look quaint. For one, hedge funds do billions of dollars of business in multiple parts of the bank, while many technology companies promptly evaporated after going public.

“Every prime broker has taken note,” said the head of prime brokerage at a top Wall Street firm. “It raises the bar in what we need to know about a client and escalation when there is cause for concern.”

Prime brokerage is the business of servicing hedge funds — finding and lending stock to allow hedge funds to short (a bet the price will fall), financing trades (leverage) and structuring swaps, among other things (services vary by firm). Wall Street firms earned $8 billion to $10 billion from prime brokerage activities last year.

Hedge fund relationships forged through prime brokerage relationships are critical to banks who can then deliver countless other services to hedge funds: trading over-the-counter derivatives, selling exotic stock or bond deals or structuring hedges. If prime brokerage is an increasingly commoditized product, its significance in generating business is not.

The relationship between prime brokers and hedge funds is a naturally strained one: Prime brokers want as much information as possible and hedge funds want to give them as little as possible. After all, most banks are in the same business as hedge funds (looking for investment ideas and making money from them). Most hedge funds use multiple prime brokers.

In general, prime brokers operate with the assurance that if a client blows up, they are not on the line for the losses. Unless they have actual knowledge of a fraud, they should be O.K.

Until now.

The case involving Bear Stearns had its origins in 1996, when Michael Berger, an enterprising young Austrian, began the Manhattan Investment Fund. He bet that technology stocks would fall and when they didn't, he constructed an elaborate scheme to hide his losses — about $400 million. The S.E.C. sued, and Mr. Berger pleaded guilty to securities fraud in 2000. The fund declared bankruptcy and Mr. Berger fled the country.

Angry investors tried to sue a number of deep-pocketed parties, including Bear Stearns, who was the prime broker, for aiding and abetting the fraud. A federal judge threw that case out in 2001.

Then the trustee tried something different: she sued Bear Stearns in bankruptcy court for $141.4 million — money that Manhattan Investment gave to Bear Stearns in the year before the collapse to allow Mr. Berger to trade. Those funds were later used for collateral to keep trading and to cover short positions once things started to fall apart.

Bear Stearns, the trustee argued, was not merely a "conduit" for funds, but an actual "transferee" — which in bankruptcy means the creditors can come after it. She argued that Bear Stearns did not accept the transfers in good faith — essentially saying that the investment bank should have known about the fraud.

Bear Stearns countered that it could not be a "transferee" because the funds did not belong to it. Under customer protection rules set by the S.E.C. and margin requirements set by the Federal Reserve and the New York Stock Exchange, the funds belonged to the Manhattan Investment Fund. It also argued that Bear made "good faith" efforts to uncover the fraud.

The judge didn't buy either argument, saying that the investment bank used the funds to cover positions it would have been on the hook for, making it a legitimate transferee. Bear Stearns said it was disappointed with the judge's decision which "was not supported by either the law or the facts." It will appeal the case.

Judge Lifland's opinion is a stark reminder that once a fund blows up, the look backward for red flags is never a pretty one. It poses a tough question for Wall Street: What does it need to know about its clients?

Seems simple. It may not be.

For example, did Bear Stearns fail to make a good-faith effort? In 1998, a prime brokerage executive who had nothing to do with the Manhattan Investment Fund, got wind at a cocktail party that the fund was up 20 percent, which seemed to contradict information he had inadvertently received — this was not his client — that the fund was losing money. He asked Mr. Berger to explain. Mr. Berger said he had multiple prime brokers — an explanation all parties agree was plausible. He made other efforts. But it was two years before Bear realized Manhattan was a fraud and reported it to the S.E.C.

The judge deemed those efforts insufficient.

And now prime brokers, once off limits, suddenly look more promising.

"It was such an ironclad gate for so long and now there's an opening of the door," said Ross B. Intelisano, a partner at the New law firm of Rich & Intelisano.

A door Wall Street would prefer stay shut.